

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Hill Analyst: Jessica Matus Bill Number: AB 50

Related Bills: See Legislative History Telephone: 845-6310 Introduced Date: December 6, 2010

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Exclusion/Compensation Received From PG&E/San Bruno Gas Explosion

SUMMARY

For the victims of the September 9, 2010, San Bruno natural gas transmission line explosion and fire (hereinafter "explosion"), this bill would do the following:

- Make compensation received from Pacific Gas and Electric Company (PG&E) not taxable for state purposes, and
- Make gains from the involuntary conversion of destroyed property not taxable for state purposes.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to prevent victims of the explosion from suffering further harm by incurring a tax obligation on compensation received from PG&E.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for PG&E compensation received by victims of the explosion or involuntary conversions of property damaged by the explosion occurring on or after September 9, 2010.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

The bill language contains a spelling error and an unnecessary phrase. Amendments are provided below under "Technical Considerations" that would address these matters.

PROGRAM BACKGROUND

On September 9, 2010, a natural gas transmission line exploded causing a fire to burn within the City of San Bruno, which is within San Mateo County, causing damage to approximately 175 homes, of which 53 were completely destroyed. On September 10, 2010, acting Governor Abel Maldonado proclaimed a state of emergency declaring the explosion site to be a state disaster. President Obama did not declare the explosion to be a federal disaster. On October 19, 2010, Governor Arnold Schwarzenegger signed ABX6 11 (Hill, Stats. 2010, 6th Ex. Sess.Ch. 2.) into law allowing preferential tax treatment, called disaster loss treatment, for losses sustained as a result of the explosion.

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As a result of the explosion, insurance claims, compensation settlements, and offers to purchase property have been made to assist the affected residents and property owners of San Bruno. In some cases, compensation received by those residents may be taxable under federal and California income tax laws. The IRS recently provided the Franchise Tax Board (FTB) answers to frequently asked questions to help taxpayers determine the taxability of this compensation. (See Appendix A.)

ANALYSIS

FEDERAL/STATE LAW

Existing federal and state laws provide that gross income includes all income from whatever source derived, including compensation for services, business income, gains from property, interest, dividends, rents, and royalties, unless specifically excluded.

Current federal and state laws allow taxpayers to exclude the following from gross income:

- Amounts received as a result of a fire, flood, or other casualty if the amounts are received by an individual under an insurance contract;
- Gain from the sale or exchange of property if the property, for two of the five years prior to the sale, was owned and used as the taxpayer's principal residence. The allowable exclusion is \$250,000 (\$500,000 for taxpayers who are married filing jointly);
- Gain from the involuntary conversion of property, resulting from destruction, into similar property¹ or into money used to acquire replacement property within a specified period. "Involuntary conversion" means the replacement of property that was destroyed through no fault of the owner.
- Disaster relief compensation made for qualified disasters, with limitations as described below.

Current federal² and state tax laws allow disaster relief compensation made to individuals because of a qualified disaster to be excluded from gross income only if the funds are used for either of the following:

- To pay for personal, family, living, or funeral expenses that were incurred as a result of the qualifying disaster.
- To pay for expenses for rehabilitation or replacement of a personal residence or rehabilitation or replacement of belongings incurred as a result of the qualifying disaster.

Disaster relief compensation is excludable only to the extent that any expense is not already compensated by insurance or otherwise.

A qualified disaster is defined as a disaster which results from a terroristic or military action (as defined in IRC section 692(c)(2)), a Presidentially declared disaster, a disaster which results from an accident involving a common carrier or from any other event which would be determined by the Secretary to be of a catastrophic nature, or, for purposes of payments made by a Federal, State or local government, a disaster designated by Federal, State or local authorities to warrant assistance.

¹ Any gain is deferred until the sale of the replacement property.

² Internal Revenue Code section 139.

Under current federal and state tax laws taxpayers that received compensation from PG&E as a result of the explosion may be required to include the compensation in the calculation of gross income depending on the facts and circumstances for each particular taxpayer.

THIS BILL

This bill would treat the explosion as a qualified disaster and treat any compensation provided by PG&E to victims of the explosion as a qualified disaster relief payment excludable from gross income under current law.

Additionally, this bill would allow victims of the explosion to exclude from income any gain from the compulsory or involuntary conversion of their property as a result of its destruction, in whole or in part, by the explosion. (Under current law gain from the compulsory or involuntary conversion of property may be merely postponed until the sale of the replacement property.)

IMPLEMENTATION CONSIDERATIONS

The terms "victim" and "compensation" are undefined in the bill. These terms could have a broad meaning and may lead to disputes between the department and taxpayers. The author may wish to amend the bill to include definitions.

The terms "compulsory or involuntary conversion" are used without reference to the provisions of existing law pertaining to involuntary conversions. For clarity, the author may wish to amend the bill to reference the applicable provisions of existing law.

TECHNICAL CONSIDERATIONS

On page 2, line 9, strikeout "treaded" and insert "treated".

On page 2, line 10, strikeout "Section 17131, within the meaning of".

LEGISLATIVE HISTORY

ABX6 11 (Hill, Stats. 2010, 6th Ex. Sess. Ch. 2) allows disaster loss treatment for losses sustained as a result of the explosion and fire that occurred in San Mateo County in September 2010.

OTHER STATES' INFORMATION

Illinois, Massachusetts, Minnesota, and New York conform to the federal provisions related to gross income exclusions for disaster losses and involuntary conversions. As a result, compensation received due to a specified disaster or income received from an involuntary conversion of property is automatically excluded from income in these states. Similarly, it appears that legislation, executive order, or proclamation by the President or the Governor is required to identify the area impacted by a disaster that is eligible for federal or state assistance.

Florida has no personal income tax, thus its laws are not applicable.

These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 50 PG&E Immediate Relief Compensation For Taxable Years Beginning On Or After January 1, 2011 Enactment Assumed After June 30, 2011		
2010-11	2011-12	2012-13
-\$600,000	-\$36,000	-\$30,000

This estimate does not account for changes in employment, personal income, or gross state product that could result from this bill.

This estimate assumes the compensation received from PG&E for damages is one hundred percent taxable at the federal level because neither the President nor the Secretary of the Treasury has declared the explosion to be a disaster. This estimate may be revised in the event the Treasury Department makes a determination that some compensation from PG&E is not includable in gross income.

Further, based on limited data available regarding taxable gains on involuntary conversions for these taxpayers, this estimate assumes for every \$1 million in conversion gains, there would be a \$60,000 revenue loss over a two-year period.

POLICY CONCERNS

Under the terms of this bill, any payments made from PG&E to victims of the explosion—regardless of reason—would remain excludable from gross income indefinitely. The lack of any limit in this regard could result in income being excluded from tax for reasons other than those intended. Accordingly, the author may wish to amend the language to provide a limitation as to grounds for the compensation.

LEGISLATIVE STAFF CONTACT

Legislative Analyst

Jessica Matus

(916) 845-6310

Jessica.matus@ftb.ca.gov

Revenue Manager

Monica Trefz

(916) 845-4002

monica.trefz@ftb.ca.gov

Legislative Director

Brian Putler

(916) 845-6333

Brian.putler@ftb.ca.gov

Appendix A

IRS' Q&As

Gas Pipeline Explosion and Fire - San Bruno, CA

Q-1: Is a taxpayer required to include in gross income payments the taxpayer receives for property damage or destruction?

A-1: A taxpayer is not required to include in gross income payments the taxpayer receives for property damage or destruction if the payments do not exceed the taxpayer's adjusted basis in the damaged or destroyed property. If the payments for property damage or destruction exceed the taxpayer's adjusted basis in the damaged or destroyed property, the taxpayer will realize gain for federal income tax purposes. However, if the property that is destroyed is the taxpayer's principal residence, the destruction is an "involuntary conversion" that is treated as a sale of the home and the taxpayer may exclude up to \$250,000 of the gain (\$500,000 if married filing jointly). See Publication 523, **Selling Your Home**. In addition, the taxpayer may defer the tax on any gain that exceeds these amounts if the taxpayer purchases qualifying replacement property that costs at least as much as the payments received for the damaged or destroyed property. (Tax is deferred until the qualifying replacement property is later sold.) An involuntary conversion occurs when a taxpayer's property is destroyed, stolen, condemned, or disposed of under the threat of condemnation and the taxpayer receives other property or money in payment, such as a condemnation award or insurance. See Publication 544, **Sales and Other Dispositions of Assets**. The person making payments for property damage or destruction is not required to file information returns with the IRS reporting the payments.

Q-2: Can a taxpayer claim a casualty loss deduction if payments the taxpayer receives for property that has been damaged or destroyed are less than the taxpayer's adjusted basis in the property?

A-2: Yes. A taxpayer may claim a casualty loss deduction if the payments (including insurance proceeds or payments for damages) the taxpayer receives, or reasonably expects to receive, are less than the taxpayer's adjusted basis in the property. See A-3, below, for a discussion of how to compute the possible deduction.

Q-3: How does a taxpayer determine the amount the taxpayer may claim as a casualty loss deduction?

A-3: With respect to personal use property, the taxpayer may generally claim as a casualty loss deduction the lesser of (1) the difference between the fair market value of the property immediately before and after the casualty; or (2) the adjusted basis of the property. The amount of the deduction is reduced by any insurance proceeds or other payments the taxpayer receives or reasonably expects to receive. An individual taxpayer must reduce the amount claimed for each casualty loss deduction for personal-use property by \$100, and reduce the total amount of casualty loss deductions claimed for personal-use property for one taxable year by 10 percent of the taxpayer's adjusted gross income.

With respect to business or income-producing property that is partially destroyed, the taxpayer generally may claim as a casualty loss deduction the lesser of (1) the difference between the fair market value of the property immediately before and after the casualty; or (2) the adjusted basis of the property. The amount of the deduction is reduced by any insurance proceeds or other payments the taxpayer receives or reasonably expects to receive. However, if business or income-producing property is completely destroyed and its adjusted basis exceeds its fair market value, the taxpayer may claim a casualty loss deduction equal to the adjusted basis of the property, reduced by payments the taxpayer receives or reasonably expects to receive for the property (including insurance proceeds or payments for damages).

Q-4: How does a taxpayer establish the decrease in the fair market value of the property after a casualty?

A-4: A taxpayer may use either an appraisal or the cost to repair or clean up the property to determine the decrease in fair market value of the property after a casualty.

Q-5: How does a taxpayer report a casualty loss deduction on its tax return?

A-5: A taxpayer claims a casualty loss deduction on the tax return for the year in which the casualty occurred. An individual taxpayer claims a casualty loss deduction for personal-use property by reporting the amount of the loss on Form 4684, **Casualties and Thefts**, and claiming an itemized deduction on Schedule A, Itemized Deductions, of the taxpayer's return. A taxpayer claims a casualty loss deduction for business or income-producing property on Section B of Form 4684, and on Form 4797, **Sales of Business Property**, if required. For more information on casualty losses, see Publication 547, **Casualties, Disasters, and Thefts**, and Publication 584, **Casualty, Disaster, and Theft Loss Workbook**.

Q-6: Is a taxpayer required to include in gross income payments the taxpayer receives for lost business income (including lost rental income) or lost profits?

A-6: Yes. A taxpayer is required to include in gross income payments the taxpayer receives for lost business income (including lost rental income) or lost profits. For information on whether estimated tax payments may be required, see Publication 505, **Tax Withholding and Estimated Tax**.

Q-7: Is an individual required to include in gross income payments the individual receives for personal physical injuries or physical sickness, or for emotional distress that is attributable to personal physical injuries or physical sickness?

A-7: No. An individual generally is not required to include in gross income payments the individual receives on account of personal physical injuries or physical sickness. Personal physical injuries include observable bodily harm such as bruises, cuts, swelling, and bleeding. Likewise, an individual is not required to include in gross income payments the individual receives for emotional distress that is attributable to personal physical injuries or physical sickness. Payments for personal physical injuries or physical sickness, or emotional distress attributable to personal physical injuries or physical sickness, are not required to be reported on an information return filed with the IRS by the person making the payment.

Q-8: Is an individual required to include in gross income compensatory damages the individual receives on account of wrongful death or loss of consortium?

A-8: No. An individual is not required to include in gross income compensatory damages the individual receives on account of wrongful death or loss of consortium.